



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
Attn: Mandatory Review, MC 4920 DAL  
1100 Commerce St.  
Dallas, TX 75242

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Date: June 5, 2008

Release Number: 200842058

Release Date: 10/17/08

UIL Code: 501.15-00

XX = Date

Address = address

Legend

ORG = Organization name

ORG

ADDRESS

Employer Identification Number:

Person to Contact/ID Number:

Contact Numbers:

**CERTIFIED MAIL – RETURN RECEIPT REQUESTED**

Dear .

In a determination letter dated November 19XX, you were held to be exempt from Federal income tax under section 501(c)(15) of the Internal Revenue Code (the Code).

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(15) of the Code. Accordingly, your exemption from Federal income tax is revoked effective January 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(15) of the Code.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On June 12, 20XX, you signed Form 6018-A, *Consent to Proposed Action*, agreeing to the revocation of your exempt status under section 501(c)(15) of the Code.

You have filed taxable returns on Form[s] 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, for the year[s] ended December 31, 20XX & 20XX with us. For future periods, you are required to file Form 1120-PC with the appropriate service center indicated in the instructions for the return.

You have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets

prompt and proper handling. You may call toll-free, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,

Marsha A. Ramirez  
Director, EO Examinations

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
<b>Explanation of Items</b>		
<b>Name of Taxpayer</b> <b>ORG</b>		<b>Year/Period Ended</b> 12/31/20XX

**LEGEND**

ORG = Organization name      XX = Date      XYZ = State      CO-1, CO-23, CO-3, CO-4, CO-5, CO-6, CO-7 & CO-8 = 1<sup>ST</sup>, 2<sup>ND</sup>, 3<sup>RD</sup>, 4<sup>TH</sup>, 5<sup>TH</sup>, 6<sup>TH</sup>, 7<sup>TH</sup>, & 8<sup>TH</sup> COMPANIES

**ISSUES**

1. Does ORG qualify for tax exempt status under Internal Revenue Code (IRC) Section 501(c)(15), for the years beginning January 1, 20XX?
2. If ORG does not qualify for tax exempt status for years beginning January 1, 20XX, what are the tax consequences?
3. If the tax exempt status is revoked, how will it affect future years?

**FACTS**

ORG (ORG) is a mutual insurance company formed in the State of XYZ in 19XX. The only type of insurance it sells is property insurance. Coverage includes fire, lightning and extended coverage. Policies are usually written for 3 year periods.

Application Form 1024 and determination letter was not available at the time of the audit. According to information secured from the Service's database, organization is tax exempt under Internal Revenue Code section 501(c)(15) and has a Form 990 filing requirement.

The Articles of Incorporation that was filed in 19XX with the State of XYZ state the purpose of the organization to be to engage in all kinds of insurance business as a county mutual insurance company as may now or hereafter be authorized under the laws of the State of XYZ, and without limiting said objectives, to engage in all the insurance business set forth under the provisions of the general statute of XYZ Chapter , Article , Section , Subsection ...

It also states that every person, association, firm, or corporation insured by this corporation shall be a member thereof and entitled to one vote.

ORG provided a Declaration page on one of the insured. The page showed insurance on a one story, framed, approved roof, storage building. Insurance covered fire and lightning, and extended coverage. The policy was written for a 3 year period, 20XX-. The amount that was covered was \$ with a premium of \$.

ORG was involved in reinsurance agreements. One agreement was a CO-7. The reinsurers were CO-1; CO-2 CO-3; CO-4; The CO-5; and The CO-6. ORG was to cede

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the organization's surplus liability on risks covered hereunder, subject to limits set forth herein. Cessions shall be limited to an amount equal to three times the organization's net retention, subject to a minimum retention of \$ and to a maximum cession hereunder of \$ on any one risk covered hereunder. However, if the cession is greater than \$, the maximum cessions as respects any one animal shall not exceed \$. Premiums- exact proportion of Gross Net Written Premium Income. Commissions were 20%.

ORG was also involved in an Interest and Liabilities Agreement. The agreement listed the same reinsurers as above. A breakdown of the percentages of each reinsurer was as follows:

- CO-1 37.50%
- CO-2 CO-3 15.00%
- CO-7 4.00%
- The CO-5 32.50%
- The CO-6 11.00%

Premium and Loss Payments to made to CO-8. Brokerage earned by CO-8 shall be deducted from ceded premiums at a rate of %.

- Coverage: Pro Rata Share – Property Business
  - Maximum Cession: \$
  - Minimum Retention: \$
  - Lines:

There were policies in force at the end of 20XX. The amount of policies in force at the end of 20XX was \$.

Form 990 was filed for the 20XX tax year. The following is a breakdown of the Gross Receipts received by ORG for the year ending December 31, 20XX, and the percentage of Gross Premiums to Gross Receipts for the same year per Notice 2006-42.

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ORG	20XX
Premiums	
Premium Refunds added back in	
Reinsurance Premiums added back in	
Total Premiums	
Investment Income	
Capital Gains/(Losses)	
Other Revenue	
Total Gross Receipts	
Percentage- Gross Premium/Reinsurance Income to Gross Receipts	

In reporting its premium income on Form 990, the organization deducted premiums refunded and premiums reinsured from total premiums. In computing total premiums and gross receipts per Notice 2006-42, these two amounts should not have been deducted. The chart above shows them being added back in to arrive at total premiums and gross receipts.

ORG received rental income that was deducted against the rental expense in the trial balance so the income never showed as part of gross receipts on the Form 990. The income is included in the computation of gross receipts in the chart above.

An election under IRC 831(b) has never been filed. As of the writing of this report, there has never been a filing of the election, either with the filing of the Forms 990 or separately.

## **LAW AND ANALYSIS**

### **1. Does ORG qualify for tax exempt status under Internal Revenue Code (IRC) Section 501(c)(15) for the years beginning January 1, 20XX?**

Internal Revenue Code section 501(c)(15)(A) exempts from Federal income tax insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if-

- (i.) (I) the gross receipts for the taxable year do not exceed \$600,000 and

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- (II) more than 50 percent of such gross receipts consist of premiums, or
- (ii.) in the case of a mutual insurance company-
- (I) the gross receipts of which for the taxable year do not exceed \$150,000 and,
  - (II) more than 35 percent of such gross receipts consist of premiums.

Clause (ii) shall not apply to a company if any employee of the company, or a member of the employee's family (as defined in section 2032(A)(e)(2), is an employee of another company exempt from taxation by reason of this paragraph (or would be so exempt but for this sentence).

Sec. 206, Clarification of Exemption from Tax for Small Property and Casualty Insurance Companies, of the Pension Funding Equity Act of 2004, P.L. 108-218, amended section 501(c)(15)(A) to change the definition of small property and casualty insurance companies (insurance companies other than life insurance companies) exempt from income taxes to: (1) a company whose gross receipts for the taxable year do not exceed \$600,000, and over half such gross receipts consist of premiums (currently, whose net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$350,000); or (2) a mutual insurance company (a) whose gross receipts for the taxable year do not exceed \$150,000 and more than 35 percent of which consist of premiums and (b) none of whose employees (or member of the employee's family) is an employee of another company exempt from tax under section 501(c)(15). These changes were applicable after December 31, 2003.

Notice 2006-42, IRB, 2006-19 provides guidance as to the meaning of "gross receipts" for purposes of section 501(c)(15)(A) of the Internal Revenue Code. This notice advises taxpayers that the Service will include amounts received from the following sources during the taxable year in "gross receipts" for purposes of § 501(c)(15)(A):

- A. Premiums (including deposits and assessments), without reduction for return premiums or premiums paid for reinsurance;
- B. Items described in § 834(b) (gross investment income of a non-life insurance company); and
- C. Other items that are properly included in the taxpayer's gross income under subchapter B of chapter 1, subtitle A, of the Code.

Thus, gross receipts include both tax-free interest and the gain (but not the entire amount realized) from the sale or exchange of capital assets, because those items are described in § 834(b). Gross receipts do not, however, include amounts other than premium income or gross investment income unless those amounts are otherwise included in gross income. Accordingly, the term gross receipts does not include



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contributions to capital excluded from gross income under § 118, or salvage or reinsurance recovered accounted for as offsets to losses incurred under § 832(b)(5)(A)(i).

Section 834(b)(1)(D) of the Internal Revenue Code includes under gross receipts the gains from the sale or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses).

Section 834(c)(6) of the Internal Revenue Code allows a deduction for Capital Losses to the extent provided in subchapter P (section 1201 and following) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders.

Based on the changes in the limitations under Internal Revenue Code (IRC) Section 501(c)(15)(A), and the operation of ORG during 20XX, it was determined from the chart above that ORG did not qualify for tax exempt status for the years beginning January 1, 20XX. ORG was able to meet the Gross Receipts Limitation of \$600,000 (\$) but was unable to meet the more than 50% requirement of Gross Premiums to Gross Receipts (%).

Since ORG is a mutual insurance company, it had the chance to meet the second set of requirements specific to mutual companies. Based on the chart above, ORG was unable to meet the second set of requirements because ORG's Gross Receipts exceeded the \$150,000 limitation (\$) and the Gross Premiums to Gross Receipts percentage did not meet the more than 35% requirement (%).

Section 206(e) of the Pension Funding Act of 2004, P.L. 118-218 provides the effective date of the new requirements for exemption under IRC 501(c)(15). It states:

#### **EFFECTIVE DATE-**

(1) **IN GENERAL-** Except as provided in paragraph (2), the amendments made by this section shall apply to **taxable years beginning after December 31, 2003.**

(2) **TRANSITION RULE FOR COMPANIES IN RECEIVERSHIP OR LIQUIDATION-** In the case of a company or association which--

(A) for the taxable year which includes April 1, 2004, meets the requirements of section 501(c)(15)(A) of the Internal Revenue Code of 1986, as in effect for the last taxable year beginning before January 1, 2004, and

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(B) on April 1, 2004, is in a receivership, liquidation, or similar proceeding under the supervision of a State court, the amendments made by this section shall apply to taxable years beginning after the earlier of the date such proceeding ends or December 31, 2007.

ORG was not involved in a court ordered liquidation during 20XX. Therefore, Section 206(e)(2) does not apply to this organization.

Therefore, for the years beginning January 1, 20XX, ORG did not qualify for tax exempt status under IRC 501(c)(15).

**2. If ORG does not qualify for tax exempt status for years beginning January 1, 20XX, what are the tax consequences?**

Since ORG did not qualify for tax exempt status under IRC Section 501(c)(15) for the years beginning January 1, 20XX, ORG's tax exempt status should be revoked for years beginning January 1, 20XX. ORG's filings of the Forms 990 were incorrect. ORG should have filed Form 1120-PC for years beginning January 1, 20XX.

IRC 831 discusses tax on insurance companies other than life insurance companies.

IRC 831(a) states as a general rule, "Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company."

IRC 831(b) provides an alternative tax for certain small companies. It states in IRC 831(b)(1) that, in general, "In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11(b)."

IRC 831(b)(2) discusses the companies to which this subsection applies.

- (A) In general. This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if-
- (i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$1,200,000 and
  - (ii) such company elects the application of this subsection for such taxable year.



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The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (1) are met. Such election, once made, may be revoked only with the consent of the Secretary.

Regulations (Regs.) 301.9100-8(a)(2) discusses the time for making elections. Under (i) it states in general that except as otherwise provided in this section, the elections described in paragraph (a)(1) of this section, must be made by the later of-

- (A) The due date (taking into account any extensions of time to file obtained by the taxpayer) of the tax return for the first taxable year for which the election is effective, or
- (B) January 22, 1990 (in which case the election generally must be made by amended return)

Regs. 301.9100-8(a)(1) mentioned above includes IRC 831(b)(2)(A).

Regs. 301.9100-8(a)(3) describes the manner of making elections. It states, " Except otherwise provided in this section, the elections described in paragraph (a)(1) of this section must be made by attaching a statement to the tax return for the first taxable year for which the election is to be effective."

Based on the Code and Regulation sections above, ORG is not entitled to the relief under 831(b), for years under examination and for any future year, until they decide to file the election. The election has never been filed, either with the Form 990 or separately. Any election filed now or in the future would only be effective for the year the election was filed and all subsequent years. The election can not be made retroactive.

### **3. If the tax exempt status is revoked, how will it affect future years?**

The tax exempt status should be revoked for the years beginning January 1, 20XX. Form 1120-PC is required for each year and all future years where ORG does not qualify for exemption. If ORG meets the requirements under IRC 501(c)(15) in future years, it may be allowed to file the Form 990 for each year they qualify, as a self-declared entity. Otherwise, Form 1120-PC would be required. Any year in the future that the Form 1120-PC is required, ORG is allowed to make an election under IRC 831(b). Once the election is made, it is effective for the year the election was made and for all future years that the Form 1120-PC is required. The election can not be made retroactive.

### **TAXPAYER'S POSITION**

Unknown at the time of this writing

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### **SUMMARY**

It is the Governments position, based on the above facts, law and analysis, that the tax exemption status of ORG for the years beginning January 1, 20XX, should be revoked based on not meeting the qualifications for exemption under IRC 501(c)(15). Form 1120-PC would be required to be filed for any year where ORG does not qualify for exemption under IRC 501(c)(15).



# DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

1100 Commerce Street

Dallas, TX 75242

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

June 5, 2008

LEGEND

ORG = Organization name

XX = Date

XYZ = State

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

December 31, 20XX

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

We have also enclosed Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues, and Publication 3498, *The Examination Process*. These publications include information on your rights as a taxpayer, including administrative appeal procedures within the Internal Revenue Service.

If you request a conference with Appeals, we will forward your written statement of protest to the Appeals Office, and they will contact you. For your convenience, an envelope is enclosed. If you and Appeals do not agree on some or all of the issues after your Appeals conference, the Appeals Office will advise you of its final decision.

If you elect not to request Appeals consideration but instead accept our findings, please sign and return the enclosed Form 6018-A, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking your exempt status under I.R.C. § 501(c)(15). If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and send a final letter advising of our determination.

In either situation outlined in the paragraph above (execution of Form 6018-A or failure to respond within 30 days), you are required to file federal income tax returns for the tax period(s) shown above, for all years still open under the statute of limitations, and for all later years. File the federal tax return for the tax period(s) shown above with this agent.

within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free and ask for Taxpayer Advocate Assistance.

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez  
Director, EO Examinations

Enclosures:

Publication 892  
Publication 3498  
Form 6018-A  
Report of Examination  
Envelope